Supreme Court, U.S.
FILED
JUN 2 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-984

In The

Supreme Court of the United States

October Term, 1987

SHELL OIL COMPANY,
Appellant,

v.

IOWA DEPARTMENT OF REVENUE,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF IOWA

AMICUS CURIAE BRIEF OF THE STATE OF CALIFORNIA IN SUPPORT OF APPELLEE

JOHN K. VAN DE KAMP
Attorney General
of the State of California
ROBERT F. TYLER
Supervising Deputy
Attorney General

ROBERT D. MILAM
Deputy Attorney General
(Counsel of Record)

Attorneys for Amicus Curiae
State of California

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333
or call collect (402) 342-2831

TABLE OF CONTENTS

Page

STATEMENT OF INTEREST 1

ARGUMENT:

I. STATES PROPERLY APPLY A FORMULA TO A TAXPAYER'S TOTAL BUSINESS INCOME TO DETERMINE WHAT PORTIONS OF THAT INCOME ARE DERIVED FROM WITHIN AND WITHOUT THE STATE 2

II. THE INCLUSION BY A STATE IN ITS APPORTIONABLE INCOME BASE OF INCOME WHICH APPELLANT ATTRIBUTES BY THE USE OF SEPARATE ACCOUNTING TO THE OUTER CONTINENTAL SHELF DOES NOT RESULT IN THE TAXING OF INCOME DERIVED FROM THE OUTER CONTINENTAL SHELF 7

CONCLUSION 10

TABLE OF CASES CITED

	Pages
ASARCO, Inc. v. Idaho State Tax Commissioner, 458 U.S. 307, 73 L.Ed. 787, 102 S.Ct. 3103 (1982)	9
Bass, Etc., Ltd. v. Tax Commissioner, 266 U.S. 271 (1924)	5, 6
Butler Bros. v. McColgan, 315 U.S. 501 (1942)	4, 6, 8
Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983)	6, 9
Honolulu Oil Corporation v. Franchise Tax Board, 60 Cal.2d 417 (1983)	3
Mobil Oil Corporation v. Commissioner of Taxes, 445 U.S. 425 (1980)	6, 8
Moorman Mfg. Co. v. Blair, 437 U.S. 267 (1978)	6
N & W Ry. Co. v. No. Carolina, 297 U.S. 682 (1935)	6
Superior Oil Company v. Franchise Tax Board, 60 Cal.2d 406 (1963)	3
Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920)	4, 5

TABLE OF CODES, STATUTES AND OTHER AUTHORITIES

California Revenue and Taxation Code Section 25101	1
California Revenue and Taxation Code Section 25120	3
Keesling and Warren, The Unitary Concept in the Allocation of Income (1960) 12 Hast. L. Rev. 42	4
State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups, 25 Tax L. Rev. 171, 205 (1970)	9

No. 87-984

—o—

In The

Supreme Court of the United States

October Term, 1987

—o—

SHELL OIL COMPANY,

Appellant,

v.

IOWA DEPARTMENT OF REVENUE,

Appellee.

—o—

ON APPEAL FROM THE SUPREME COURT OF IOWA

—o—

AMICUS CURIAE BRIEF OF THE STATE OF CALIFORNIA IN SUPPORT OF APPELLEE

—o—

STATEMENT OF INTEREST OF CALIFORNIA AS AMICUS CURIAE

The State of California is among the 46 states which impose a tax on or measured by income attributable to sources within their respective borders. California Revenue and Taxation Code § 25101. All of the states imposing this kind of tax use some form of formula apportionment to determine the amount of income attributable to sources within and without the state. California and most other states have adopted the Uniform Division of Income for Tax Purposes Act. These states use a three-factor formula. Iowa uses a one-factor formula. All states apply their

respective formulas to the total amount of unitary business income, as defined by the state. The amounts of income and the factors included in this calculation may vary from state to state, depending on how the state defines the geographic area which comprises the unitary tax base. These variations, however, have no relevance to the issues of this case.

Appellant challenges Iowa's ability to include the income which appellant attributes to the Outer Continental Shelf in the amount of unitary business income which is apportioned by formula, on the basis that Iowa is prohibited from doing so by the Outer Continental Shelf Lands Act. Appellant's challenge goes to the very heart of the entire unitary method of formula apportionment of income, which is used by California, Iowa and 44 other states. If the states were denied the use of this method, they would be unable to fairly and efficiently administer the taxation of multistate businesses. California thus has a vital interest in preserving from this challenge the system of formula apportionment of income on which it relies to produce a substantial portion of its revenues.

———o———

ARGUMENT

I. STATES PROPERLY APPLY A FORMULA TO A TAXPAYER'S TOTAL BUSINESS INCOME TO DETERMINE WHAT PORTIONS OF THAT INCOME ARE DERIVED FROM WITHIN AND WITHOUT THE STATE.

California has been administering a system of formula apportionment for over fifty years, and its system has

been fully tested in the state and federal courts. California's system is illustrative of, and comparable to, the systems employed by Iowa and most other states, in that respective tax bases generally include income and factors from activities on the Outer Continental Shelf. For the purpose of illustration, this discussion is confined to California law, insofar as it describes a particular state system of apportionment.

The unitary business/formula apportionment method of accounting is now codified in the Uniform Division of Income for Tax Purposes Act, which California adopted in 1966. California Revenue and Taxation Code Section 25120, et seq. California law requires that the California income of a unitary business which operates both inside and outside California be determined through formula apportionment. *Superior Oil Company v. Franchise Tax Board* 60 Cal.2d 406, 411 (1963); *Honolulu Oil Corporation v. Franchise Tax Board* 60 Cal.2d 417, 425 (1983).

The unitary business principle has been described as follows:

> Where the properties and activities [of a corporation] within and without the jurisdiction are an inseparable portion of a business carried on both within and without the jurisdiction, the computation of the income attributable thereto requires a computation of the income of the business as a whole or as a unit and an apportionment or allocation of the total to the various parts. This necessity of dealing with the business as a *unit*, taking into account income from property and activities without the jurisdiction as well as within, gives rise to the classification of the business as a

> unitary business. Thus a unitary business may be defined simply as any business which is carried on partly within and partly without the taxing jurisdiction.

Keesling and Warren, *The Unitary Concept in the Allocation of Income* 12 Hast. L. Rev. 42, 46 (1960); emphasis in original.

Where a unitary business exists, a state is " 'faced with the impossibility of allocating specifically the profits earned by the processes within its borders.' " *Butler Bros. v. McColgan* 315 U.S. 501, 507 (1942) (quoting *Underwood Typewriter Co. v. Chamberlain* 254 U.S. 113, 121 (1920)). It is the impossibility of determining the actual source of profits and losses of a unitary business which provides the rationale for apportioning the income of such a business by means of a formula which reflects the relative extent of its business activity in each of the taxing jurisdictions involved.

The purpose of this method of apportionment is to reflect contributions of the various elements of a unitary business to the profitablity of the business as an economic whole. In most states, including California, a three-factor formula, based on property, payroll, and sales, is used. Each factor is a fraction, the numerator of which is the dollar value of the particular category attributable to the taxing jurisdiction, and the denominator of which is the dollar value of that particular category for the unitary business everywhere. The three fractions are added together and the sum is divided by three. Net income subject to apportionment is then multiplied by the resulting fraction (usually expressed as a percentage) in order to determine that portion of the total business net income which is attributable to activity within the taxing jurisdiction.

In *Underwood Typewriter Co. v. Chamberlain* 254 U.S. 113 (1920), the United States Supreme Court considered the constitutionality of the application of the unitary method to a domestic corporation which conducted business activities in several states. The court stated:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in the record, reached, and was meant to reach, only the profits earned within the State.

Underwood Typewriter Co. v. Chamberlain 254 U.S. at 120-121

Four years later, the United States Supreme Court coined the term "unitary business" in *Bass, Etc., Ltd. v. Tax Comm.*, 266 U.S. 271, 282 (1924). In *Bass*, the court held that a formula could be applied to apportion the profits of an English company which sold its ale in New York. The court stated:

> So in the present case we are of the opinion that, as the Company carried on the *unitary business* of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing a just proportion of the profits earned by the company from such *unitary business.*

Bass, Etc., Ltd. v. Tax Comm., 266 U.S. at 282; emphasis added.

The court again recognized the necessity for formula apportionment in *N & W Ry. Co. v. No. Carolina* 297 U.S. 682 (1935) and stated the following with respect to a statutory formula then under attack:

> Taxpayer and state would be swamped with administrative difficulties if left to struggle through every case without the aid of a formula of ready application. In the perplexities besetting the process of assessment the statute is the outcome of a reasonable endeavor to arrive at a proportion of general validity.

N & W Ry. Co. v. No. Carolina 297 U.S. at 685

This court has rendered a long line of decisions which recognize that formula apportionment is a valid means of determining the amount of income of a unitary business fairly attributable to sources within a particular taxing jurisdiction—that is, formula apportionment of all business income, regardless of where it would be allocated by separate accounting. See, e.g., *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159; *Exxon Corporation v. Wisconsin Department of Revenue* 447 U.S. 207 (1960); *Mobil Oil Corporation v. Commissioner of Taxes,* 445 U.S. 425; *Moorman Mfg. Co. v. Blair* 437 U.S. 267 (1978); *Butler Bros. v. McColgan,* 315 U.S. 501 (1942); *Bass, Etc. Ltd. v. Tax Commissioner,* 266 U.S. 271 (1924).

Recently, in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, this court upheld California's application of the unitary method to an organization composed of a domestic parent and several subsidiary corporations, incorporated both within the United States and various foreign countries.

II. THE INCLUSION BY A STATE IN ITS APPORTIONABLE INCOME BASE OF INCOME WHICH APPELLANT ATTRIBUTES BY THE USE OF SEPARATE ACCOUNTING TO THE OUTER CONTINENTAL SHELF DOES NOT RESULT IN THE TAXING OF INCOME DERIVED FROM THE OUTER CONTINENTAL SHELF.

There are basically two accounting methods which are employed to determine where income is earned—unitary business/formula apportionment and separate accounting. Formula apportionment views a business as a unit stretching across jurisdictional borders and attempts to allocate net income to each locality in which a business operates, in the proportion that the business activities conducted by the corporation in a particular locality bears to the business activities conducted by the corporation in all localities. Separate accounting views the various localities of a multistate or multinational enterprise as functionally separate from one another and determines the income attributable to any particular jurisdiction on the basis of geographical and transactional accounting records maintained for the activity of the unit located within that jurisdiction.

California, Iowa, and other states use formula apportionment to attribute income to sources within and without their respective jurisdictions. In all these states, the denominator of the formula used includes the factor(s) attributable to the Outer Continental Shelf, and the numerator does not. For this reason, the income which the states apportion *outside* of their respective jurisdictions includes the income which has its source in the Outer Continental Shelf. Thus, *the very operation of the formula itself* excludes income attributable to the Outer Continen-

tal Shelf from that income attributable to, and subjected to tax by, the respective states.

Appellant, on the other hand, is using the separate accounting method to attribute income to the Outer Continental Shelf. Appellant is then asserting that because this income, which it has attributed by separate accounting to the Outer Continental Shelf, is included by Iowa in the apportionable income base, Iowa must be taxing Outer Continental Shelf income and thus asserting jurisdiction over the Outer Continental Shelf in violation of federal law.

The flaw in Shell's line of reasoning is that it is using separate accounting to show that Outer Continental Shelf income is being taxed. This it is not permitted to do.

In *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425 (1980), this court rejected the taxpayer's contention that the source of income earned by a unitary business must be ascertained by separate geographic accounting.

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. *Butler Bros. v. McColgan,* 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. at 438. Thus, in *Butler Bros.* and *Mobil, supra,* among other cases, this court has specifically disapproved of the use of

separate accounting to impeach the results of formula apportionment.

In *Container Corp. v. Franchise Tax Bd.* 463 U.S. 159, the taxpayer used the same line of reasoning now used by Shell in an effort to show that formula apportionment of total worldwide income resulted in the taxation of foreign income. In that case, the court noted that a state is not constitutionally permitted to "tax value earned outside its borders," citing *ASARCO, Inc. v. Idaho State Tax Commissioner,* 458 U.S. 307 (1982). The court evaluated California's system of formula apportionment of total worldwide income in light of this prohibition and held specifically that California's system does *not* result in taxation of extraterritorial values.

The principle is stated in Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups,* 25 Tax L. Rev. 171, 205 (1970), as follows:

> [F]oreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment—in the case of a multistate business—involve the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state.

Since the inclusion of "foreign" income in the apportionable income base has been held not to constitute taxation of extraterritorial values, it follows that inclusion of Outer Continental Shelf income in the base likewise cannot constitute taxation of Outer Continental Shelf values.

CONCLUSION

The system of formula apportionment of a unitary income base does not result in a state's taxing extraterritorial values. It reaches only income that fairly represents the extent of business activity *within* the state. By its very operation, the formula excludes from the measure of tax that portion of the total income which fairly represents all business activities which take place *without* the state, including the business activity which takes place on the Outer Continental Shelf.

Appellant seeks to use separate accounting to carve out a portion of the unitary income subject to apportionment. If appellant can use separate accounting to carve out this particular portion, what is to prevent others from using separate accounting to carve out other portions attributable to foreign countries, federal enclaves, Indian lands, and other states, until the entire unitary method is in tatters? To sustain appellant's position would be to completely undermine the theoretical and constitutional basis for the unitary method of taxation, used by California, Iowa and all other states imposing a tax on or measured by income.

This court should sustain the unitary method once again, as it has repeatedly done in the past, and reject Appellant's spurious position.

Respectfully submitted,

JOHN K. VAN DE KAMP
Attorney General
of the State of California

ROBERT F. TYLER
Supervising Deputy
Attorney General

ROBERT D. MILAM
Deputy Attorney General
(Counsel of Record)

Attorneys for Amicus Curiae
State of California